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subject: Lending in the United States by Foreign Person Giving Rise to Effectively Connected Income

This memorandum sets forth the legal analysis with respect to certain lending activities undertaken by foreign corporations. This advice may not be used or cited as precedent.

ISSUE

Whether interest income earned by a foreign corporation with respect to loans originated by an agent, whether dependent or independent, in the United States is attributable to "the U.S. office" through which the foreign corporation's banking, financing or similar business activity is carried on, such that the interest income is "effectively connected income"?

CONCLUSION

The interest income received by a foreign corporation with respect to loans that it originated to U.S. borrowers constitutes income effectively connected with such foreign corporation's banking, financing or similar business when an agent, whether dependent or independent, performs origination activities described in the facts below on the foreign corporation's behalf with respect to such loans in the United States.

FACTS

A corporation is organized in Country X (“Foreign Corporation”) and 100 percent of the shares in Foreign Corporation are held by shareholders who are not U.S. Persons as defined by Section 7701(a)(30). Country X does not have a bilateral income tax treaty with the United States. Foreign Corporation makes loans to U.S. persons (the “U.S. Borrowers”) within the United States.

Foreign Corporation has no office or employees located in the United States. To originate loans to the U.S. Borrowers, Foreign Corporation outsources the origination activities to a United States corporation (“Origination Co.”). Under a service agreement between Foreign Corporation and Origination Co., the activities performed by Origination Co. include the solicitation of U.S. Borrowers, the negotiation of the terms of the loans, the performance of the credit analyses with respect to U.S. Borrowers, and all other activities relating to loan origination other than the final approval and signing of the loan documents. Origination Co. conducts these activities on a considerable, continuous, and regular basis. Under the terms of the service agreement, Foreign Corporation pays Origination Co. an arm’s length fee for its services. Origination Co. performs the origination activities from an office located in the United States, and Origination Co. is subject to U.S. federal income taxation. Although Origination Co. performs all of the origination activities on behalf of Foreign Corporation, Origination Co. is not authorized to conclude contracts on behalf of Foreign Corporation. Foreign Corporation’s employees, who work in an office located outside of the United States, give final approval for the loans and physically sign the loan documents on behalf of Foreign Corporation.

LAW

Section 882

Pursuant to section 882(a)(1) of the Internal Revenue Code, a foreign corporation engaged in a trade or business within the United States during the taxable year is subject to U.S. federal income tax on its taxable income that is effectively connected with the conduct of a trade or business within the United States.

Definition of a “Trade or Business Within the United States”

To be subject to tax under section 882, a foreign corporation must be engaged in a “trade or business within the United States.” A “trade or business within the United States” includes the performance of personal services within the United States at any time within the taxable year” Section 864(b). The term “trade or business within the United States” does not include “[t]rading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent.” Section 864(b)(2)(A)(i). This safe harbor does not apply if the taxpayer has an office or other fixed place of business in the United States at any time during the taxable year through which the transactions in stocks or securities are effected. Section 864(b)(2)(C). In

addition, the term “trade or business within the United States” does not include “[t]rading in stocks or securities for the taxpayer’s own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other independent agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transaction.” Section 864(b)(2)(A)(ii). This clause does not apply in the case of a dealer in stocks or securities. Id.

If a foreign corporation does not qualify for the section 864(b) safe harbors, the unavailability of such safe harbors is not a determination that such foreign corporation is engaged in a trade or business within the United States. Treas. Reg. § 1.864-2(e). Rather, whether a foreign corporation is treated as engaged in a trade or business within the United States “shall be determined on the basis of the facts or circumstances in each case.” Treas. Reg. § 1.864-2(e).

Definition of “Effectively Connected Income” – U.S. Source Income

Once a foreign corporation is found to be engaged in a trade or business within the United States, the foreign corporation’s income must be “effectively connected” with the U.S. trade or business to be taxable under section 882(a). Section 864(c) defines when such foreign corporation’s income, gain or loss will be treated as effectively connected with the conduct of a United States trade or business. With respect to U.S. source interest income, when determining that such income is effectively connected with the conduct of a trade or business within the United States, the factors taken into account include whether (A) the income is derived from assets used in or held for use in the conduct of such trade or business, or (B) the activities of such trade or business were a material factor in the realization of the income. Section 864(c)(2).

Notwithstanding the “asset use test” and the “business-activities test” articulated in section 864(c)(2) and the regulations thereunder, Treas. Reg. § 1.864-4(c)(5) provides a special rule for determining whether income is effectively connected with a “banking, financing or similar business activity.” Specifically, any U.S. source interest received by a foreign corporation during the taxable year in the active conduct of a banking, financing, or similar business in the United States is treated as effectively connected to the conduct of that business “only if the stock or securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on” and the securities were acquired in one of the specified manners enumerated in the regulations, which includes making loans to the public. Treas. Reg. § 1.864-4(c)(5)(ii). A stock or security is deemed to be attributable to a U.S. office “only if such office actively and materially participates in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security.” Treas. Reg. § 1.864-4(c)(5)(iii). Treas. Reg. § 1.864-4(c)(5)(iv) provides rules for determining when a stock or security was acquired in the course of making loans to the public. Even when U.S. source income from stocks and securities is not effectively connected with the active conduct of a foreign corporation’s banking, financing or similar business in the United States, such income may be effectively connected with the conduct of another U.S. trade or business under the “asset-use test,” as provided in Treas. Reg. § 1.864-

4(c)(2), or the “business-activities test,” as provided in Treas. Reg. § 1.864-4(c)(3). Treas. Reg. § 1.864-4(c)(5)(vi).

Foreign Source Effectively Connected Income

Generally, foreign source interest income is not treated as effectively connected with the conduct of a United States trade or business. Section 864(c)(4)(A). Foreign source interest income of a foreign corporation derived from the active conduct of a banking, financing, or similar business within the United States, however, is treated as effectively connected with the conduct of a United States trade or business “if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable.” Section 864(c)(4)(B). For purposes of section 864(c)(4)(B), when determining whether a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of an agent will be disregarded unless the agent (i) has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises such authority and (ii) is not a general commission agent, broker or other independent agent acting the ordinary course of business. Section 864(c)(5)(A). In addition, a foreign corporation’s income, gain or loss will not be attributable to an office or fixed place of business in the United States unless such office or fixed place of business “is a material factor in the production of such income, gain, or loss” and the office or fixed place of business regularly carries on the type of activities from which such income, gain or loss was derived. Section 864(c)(5)(B).

Treas. Reg. § 1.864-5 provides rules for determining when a foreign corporation’s foreign source income will be treated as effectively connected with a United States trade or business. Treas. Reg. § 1.864-6 provides rules for determining when a foreign corporation that is engaged in a United States trade or business has an office or fixed place of business in the United States.

With respect to a foreign corporation that is engaged in a U.S. trade or business, Treas. Reg. § 1.864-7 defines the term “office or other fixed place of business” for the purposes of Section 864(c)(4)(B), Treas. Reg. § 1.864-6 and Treas. Reg. § 1.864-5(b), all of which are provisions relating to foreign source effectively connected income. Treas. Reg. § 1.875-7(a)(1). When determining whether a foreign corporation has an office or other fixed place of business with regard to foreign source income, the office of a dependent agent is disregarded unless such agent has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises that authority. Treas. Reg. § 1.864-7(d)(1)(i).

Source of Interest Income

The source of interest income as foreign or domestic depends upon the borrower. In general, interest income from loans made to U.S. borrowers will be sourced as income from sources within the United States. Section 861(a)(1).

ANALYSIS

Foreign Corporation is engaged in a “trade or business within the United States” pursuant to Section 864(b)(2)

Based on the facts and circumstances described above, Foreign Corporation is engaged in a trade or business within the United States.

Attribution of an Agent’s Activities

Although Origination Co. acts on behalf of Foreign Corporation pursuant to a service contract and does not have authority to conclude contracts, Origination Co. performs activities that are a component of Foreign Corporation’s lending activities, such as the solicitation of customers, the negotiation of contractual terms and the performance of credit analyses. In similar circumstances, courts have found an agency relationship to exist in fact and have attributed the activities of the U.S. agent to the foreign principal in determining whether the foreign principal conducted considerable, continuous, and regular activity within the United States. See Inverworld, Inc. v. Commissioner, T.C. Memo. 1996-301 (finding that the activities of a U.S. corporation, although nominally an independent contractor and not an agent, were attributed to a foreign corporation where the activities of the U.S. corporation were in fact those of an agent); I.R.S. Tech. Adv. Mem. 80-29-005 (March 27, 1980) (“In resolving the issue of whether the A Trusts are engaged in a trade or business within the United States for purposes of Section 864(b) of the Code, it is irrelevant whether [the company operating the A Trusts’ oil leases] is an independent contractor of the A Trusts or the actual agent of the trusts.” (citing Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff’d, 221 F.2d 227 (9th Cir. 1955))). The activities performed by Origination Co., therefore, are attributable to Foreign Corporation for purposes of determining whether Foreign Corporation engages in a trade or business within the United States.

Courts have found a U.S. trade or business where a taxpayer’s U.S. activities, either directly or through an agent, are considerable, continuous, and regular. De Amodio v. Commissioner, 34 T.C. 894, 905-06 (1960), aff’d, 299 F.2d 623 (3rd Cir. 1962) (concluding that the taxpayer had engaged in a U.S. business because the activities of taxpayer’s agent were considerable, continuous and regular, and that those activities, which constituted more than the mere ownership of real property or receipt of income from real property, were attributable to the taxpayer); Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff’d, 221 F.2d 227 (9th Cir. 1955) (concluding that the taxpayer had engaged in a U.S. business because taxpayer’s activities through an agent were considerable, continuous and regular even though the agent received the taxpayer’s approval prior to taking any important action); Handfield v. Commissioner, 23 T.C. 633, 637-38 (1955) (concluding that the taxpayer was engaged in a trade or business within the United States because an agent made substantial sales in the

United States on behalf of the taxpayer pursuant to a distribution agreement); Adda v. Commissioner, 10 T.C. 273, 277 (1948) (concluding that the taxpayer engaged in a trade or business within the United States through the activities undertaken by the taxpayer's agent). With respect to Foreign Corporation's lending business, Origination Co. undertakes activities on behalf of Foreign Corporation that are more than ministerial and clerical in nature. See Spermacet Whaling & Shipping Co. v. Commissioner, 30 T.C. 618, 634 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960) (holding that the taxpayer was not engaged in a trade or business within the United States where the U.S. activities of its agent were ministerial and clerical activities that involved "very little exercise of discretion or business judgment necessary to the production of the income"). Because the lending activities of Foreign Corporation, which were carried on by Origination Co., were considerable, continuous, and regular, Foreign Corporation is engaged in a U.S. trade or business.

Lending Trade or Business within the United States

The activities with respect to Foreign Corporation's loans to U.S. Borrowers constitute a trade or business because Foreign Corporation lends money to customers on a considerable, regular and continuous basis with the intention of earning a profit. Compare Inverworld, Inc. v. Commissioner, T.C. Memo. 1996-301 (finding that a foreign corporation was engaged in a trade or business within the United States when its activities in the United States, including lending money to clients, were regular and continuous enough to constitute "a banking, financing or similar business in the United States") with Pasquel v. Commissioner, 12 T.C.M. 1431 (1953) (finding that a taxpayer was not engaged a trade or business within the United States when the taxpayer entered into a "single and isolated" financing transaction in the United States). Such trade or business is treated as being within the United States because Foreign Corporation's loan origination activities conducted through Origination Co. occur within the United States. Adda v. Commissioner, 10 T.C. at 277-78 (finding that the taxpayer engaged in a trade or business within the United States through the activities of an agent even though the agent did not have an office in the United States); Inverworld, Inc. v. Commissioner, T.C. Memo. 1996-301; see also, e.g., Pinchot v. Commissioner, 113 F.2d 718, 719-720 (2d. Cir. 1940) (finding that the taxpayer was engaged in a U.S. business because the activities in the United States were considerable, regular and continuous).

Section 864(b)(2) Safe Harbors

Further, because Foreign Corporation regularly and continuously originates loans to customers, such activities constitute a lending trade or business and not trading or investing activities for the purpose of section 864. Compare Inverworld, T.C. Memo. 1996-301 with Higgins v. Commissioner, 312 U.S. 212 (1941) (holding that investing, no matter how extensive the activity, is not a trade or business) and Yaeger v. Commissioner, 889 F.2d 29, 33-34 (2d Cir. 1989) (holding that the taxpayer was an investor rather than a trader because the management of personal securities investment is not the trade or business of a trader and noting that the fundamental

criteria that distinguishes a trader from an investor is the length of the holding period and the source of profit). As the Foreign Corporation's lending activities do not constitute "trading" in stock and securities, Foreign Corporation does not qualify for the trading safe harbors under section 864(b)(2). Rather, based upon the facts and circumstances, Foreign Corporation is engaged in a U.S. trade or business. Treas. Reg. § 1.864-2(e).

Foreign Corporation has income effectively connected with a banking or financing business within the United States

The interest income that Foreign Corporation receives with respect to the loans originated in the United States is effectively connected with the conduct of a trade or business within the United States because Foreign Corporation is engaged in a banking business and such interest income is attributable to an office in the United States.

Banking, Financing or Similar Business Activity

Foreign Corporation is treated as engaged in a banking, financing or similar business activity within the United States as described by Treas. Reg. § 1.864-4(c)(5)(i) because its business, through the activities of Origination Co., includes making loans to the public. Because Foreign Corporation is engaged in a banking, financing, or similar business activity, its income from that business may be effectively connected with a trade or business in the United States, notwithstanding the "asset use test" or the "business activity test." Treas. Reg. § 1.864-4(c)(5)(i).

The Office Requirement of Treas. Reg. § 1.864-4(c)(5)

Foreign Corporation's U.S. source interest income from a banking, financing or similar business will be treated as effectively connected income if the securities giving rise to such income are "attributable to the U.S. office through which such business is carried on" and the securities were acquired as a result of making loans to the public. Treas. Reg. § 1.864-4(c)(5)(ii). The regulation requires that the income be attributable to "the U.S. office through which such business is carried on" Treas. Reg. § 1.864-4(c)(5)(ii) (emphasis added). The regulation does not specify or imply that the U.S. office belong to or be attributable to the taxpayer.

The Service is aware that some taxpayers may have taken the position that the interest income is not effectively connected with banking, financing or similar business activity because the income is not attributable to a U.S. office of the Foreign Corporation and that the office of Foreign Corporation's agent is not attributable to the Foreign Corporation under Treas. Reg. § 1.864-7(d). Because Treas. Reg. § 1.864-4(c)(5) does not provide guidance defining the phrase "the U.S. office," a taxpayer may argue that the definition of the phrase "office or other fixed place of business" provided in Treas. Reg. § 1.864-7 should apply to interpret the phrase "the U.S. office." Under the taxpayer's analysis, because Origination Co. is either an independent agent or does not

have the authority to conclude loans on behalf of Foreign Corporation, the office of Origination Co. is not attributable to Foreign Corporation.

This argument misapplies both the statute and the regulations. Unlike section 864(c)(4)(B), section 864(c)(2) contains no “office or other fixed place of business” requirement. Section 864(c)(4)(B) and Treas. Reg. § 1.864-7 apply only for the purpose of foreign source effectively connected income described in section 864(c)(4)(B) and the regulations thereunder. Treas. Reg. § 1.864-7(a)(1). Because the interest income received by Foreign Corporation with respect to loans made to U.S. Borrowers is U.S. source income, the definition contained in Treas. Reg. § 1.864-7 does not apply.

Notwithstanding the court’s reliance upon Treas. Reg. § 1.864-7 in Inverworld, the framework of Treas. Reg. § 1.864-7 is not relevant to the application of Treas. Reg. § 1.864-4(c)(5) in this case. In Inverworld, the court used Treas. Reg. § 1.864-7 as a framework for interpreting section 864(b)(2)(C) “because those regulations construe the phrase ‘office or other fixed place of business in the United States’, which is also found in section 864(b)(2)(C)” even though Treas. Reg. § 1.864-7 does not expressly apply to Section 864(b)(2)(C). T.C. Memo. 1996-301. As previously stated, unlike section 864(b)(2)(C) and Treas. Reg. § 1.864-7, which are concerned with whether or not the taxpayer has a U.S. office (either directly or by attribution), Treas. Reg. § 1.864-4(c)(5)(ii) does not require that the taxpayer have a U.S. office.

The rule in Treas. Reg. § 1.864-4(c)(5)(ii) elaborates a statutory provision that does not contain the same “office or other fixed place of business” requirements found in other sections. As a result, the regulation cannot be read to import the same “office or other fixed place of business” rule of section 864(c)(4)(B). It does not, for example, require by its terms that the office be the office of the taxpayer. A U.S. office of an agent of the taxpayer is sufficient. If the regulations intended that interest income must be attributable to the taxpayer’s office to be treated as effectively connected with a banking, financing or other similar business, the regulation would have explicitly stated that the income must be attributable to “the taxpayer’s office.” Alternatively, the text of the regulation would have used a possessive pronoun to indicate that the office must be the taxpayer’s office. Because the regulation requires only that the interest income be attributable to “the U.S. office,” a U.S. office of a person other than the taxpayer may satisfy the requirement. Origination Co.’s office satisfies the office requirement articulated in Treas. Reg. § 1.864-4(c)(5)(ii) because Origination Co. has an office in the United States and the day-to-day activities required of Foreign Corporation’s lending business take place from the office of Origination Co.

Interest Income Attributable to the U.S. Office

In order to have effectively connected income, the loans originated by Foreign Corporation must be attributable to a U.S. office. A loan will be attributable to a U.S. office “only if such office actively and materially participated in soliciting, negotiating or performing other activities required” for the acquisition of such loan. Treas. Reg. § 1.864-4(c)(5)(iii). Foreign Corporation has engaged Origination Co. to perform its

origination activities in the United States, including the solicitation of borrowers and the negotiation of contractual terms. For this purposes, it is enough that Origination Co. is a dependent or independent agent of the taxpayer performing activities described above. To perform loan origination activities on behalf of Foreign Corporation, Origination Co. operates from an office in the United States. Origination Co.'s U.S. office actively and materially participates in the origination of Foreign Corporation's loans to U.S. Borrowers because the activities required to originate such loans occur through that U.S. office. The income from Foreign Corporation's loans to U.S. Borrowers, therefore, is attributable to "the U.S. office" of Origination Co. through which Foreign Corporation carries on its lending business.

Because Origination Co.'s U.S. office actively and materially participated in the day-to-day origination activities, Foreign Corporation's U.S. source interest income is attributable to Origination Co.'s U.S. office, even though Foreign Corporation concluded the loans outside of the United States. Foreign Corporation's interest income with respect to loans made to U.S. Borrowers, therefore, is effectively connected with a trade or business within the United States pursuant to section 864(c)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand that foreign corporations and non-resident aliens may have used other strategies to originate loans in the United States giving rise to effectively connected income. We encourage you to develop these cases, and we stand ready to assist you in the legal analysis.

Please call Peter Merkel of the Office of the Associate Chief Counsel (International) at (202) 622-3870 (not a toll-free number) if you have any further questions.